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DO INDUSTRY AFFILIATIONS AFFECTING CORPORATE TAX AVOIDANCE IN MALAYSIA?

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ABSTRACT

Corporate tax avoidance studies have been addressed for a number of years within the developed market context, whereas corporate tax avoidance research for companies in developing countries is largely non-existent. Furthermore, prior studies of tax avoidance have stressed more individuals' behavior rather than corporations'. Industry affiliations might be a potential explanation of tax avoidance activity as this action may also depend on the sensitivity of certain industries. The objective of the study is to examine the importance of industry affiliations as possible contributions of corporate tax avoidance mechanism. This study document the link between industry affiliations and corporate tax avoidance in an emerging market. This study tests the relationship by using a cross-sectional-time series valuation using panel data analyses which is Tobit estimations. The results confirm the importance of industry differences in explaining corporate tax avoidance activity.

Field of Research: *Corporate tax avoidance, industry affiliation, tax incentives.*

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1. INTRODUCTION

Tax avoidance is the use of legal loopholes and tax allowances to reduce legitimately the size of a tax liability. These activities are referred to as aggressive tax planning, which is an attempt to reduce tax payment and often requires an intelligent application of expert knowledge to avoid tax. Lymer and Oats (2006, p.350) define tax planning as an activity that "involves strategic use of available tax concessions in order to minimize tax liability."

The principal objective of this study is to explore the industry effect towards tax planning based on tax incentives given for each industry. The benefit of this study is to observe the impact of national tax policy on financial reporting and could help explain managerial behavior. The study provides new evidence of industry effects on corporate tax avoidance activity.

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2. MALAYSIAN CORPORATE TAX

Malaysia, similar to other countries such as the UK and the US, has lowered its corporate tax rate gradually over the years, from 40 per cent in 1988 to the current rate of 26 per cent. The rationale given for this is to help ease the tax burden of the private sector, attract foreign investors and provide an incentive for companies to expand their activities. A number of tax incentives has been introduced by the Malaysian government to promote foreign investments and priority industries, particularly projects which are capital intensive, with high value added content and involving new and emerging technologies. Tax incentives are found mainly in the Promotion of Investment Act 1986 (PIA) and the Income Tax Act, 1967. The PIA is the more important legislation as it covers the major incentives available. Malaysia offers tax incentives for investments in promoted products and activities in manufacturing, agriculture, tourism including hotels, research and development (R&D) and training. Companies with MSC status, would be able to enjoy special incentives, including tax holidays for a period of up to 10 years or investment tax allowance (ITA) of 100 per cent and no duties on the import of multimedia equipment. These incentives were to encourage the development of the MSC and to ensure that there are sufficient knowledge-workers for the multimedia and information technology sector of the economy. The development of technology sectors is important in order to accomplish the Vision 2020 to be a fully developed and industrialized country by the year 2020.

3. PRIOR RESEARCH

3.1 Theoretical Background

This study presents a principal-agent model in incorporating the possibility that the manager (agent) involved in tax avoiding activity may have two motivations for tax avoiding activity, namely synergy and agency, but which also allows for the possibility of hubris occurring. Prior studies of tax avoidance have stressed more individuals' behavior rather than corporations'. Slemrod (2004) has emphasized the differences between individual and corporate tax compliance, arguing that the latter should be analyzed in a principal-agent model. The basic premise of the model is that decisions about corporate tax avoidance are made by companies' managers.

In synergy-motivated tax planning, the managers act in the interests of their shareholders to increase firm value. If tax planning activity is driven by the synergy motive, then such activity should intend to create wealth for shareholders.

Agency theory suggests that the interests of principals and agents will not necessarily coincide and rests on the assumption that managers have an incentive to maximize their personal utility and may do so even to the detriment of shareholders. Managers may avoid tax because they derive a private benefit, for example, an increase in their prestige or career prospects by making them appear more valuable to the firm, owing to their ability to reduce taxes. In other words, the main characteristics of managers that are addressed in the agency literature are opportunism and self-interest. According to Alchian and Demsetz (1972), Jensen and Meckling, (1976) and Eisenhardt (1989), in the absence of either appropriate incentives or sufficient monitoring, agents will be able to exercise their discretion to the detriment of principals. The argument is that owners wish to maximize profits, but that their designated agents may have neither the interest nor the incentive to do so.

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Hubris results from mistakes by managers in estimating the value of tax planning. Hubris emphasizes the role of managers and their personality traits. Under the hubris theory, tax planning may be initially viewed as deriving from the motivation to raise firm value and maximize shareholders' wealth. The study of hubris which is widely used in the takeover literature has attracted scholars interested in understanding the role of the neurotic and psychological disorders of top executives. The concept of hubris from the personality theory (for example, see Kets de Vries 1990 and 1991), provides a description of hubristic leaders as narcissistic personalities who long for the reassurance and the applause of others. Kets de Vries (1991) notes that, with previous successes and from consistent public acclaim for successful achievements, hubristic leaders end up believing that their achievements exceed those of their counterparts. Kroll, Toombs and Wright (2000) emphasized that hubristic leaders tend to listen only to people whose opinions are compatible with their own. Consequently, being too independent, hubristic leaders tend to make mistakes.

This study proposes that in any tax avoidance activity, elements of synergy, agency and hubris simultaneously exist and interact to determine the output of the activity. These theories aim to identify the economic motives that influence managers to make certain choices. Thus, this study tries to adapt and provide additional evidence on the principal-agent model of tax avoidance behaviour.

3.2 Tax Avoidance

The Effective Tax Rates (ETR) has been widely used to measure the tax burden of a company (for example, see Derashid and Zhang, 2003; Gupta and Newberry, 1997; Callihan, 1994; Manzon and Smith, 1994; Porcano, 1986; Spooner, 1986 and Zimmerman, 1983). Rego (2003) interpreted ETR as a measure of the effectiveness of tax planning.

There is a range of alternative formulae which may be used to define and measure ETR. Callihan (1994) and Omer et al. (1991) raise the issue of different measures of the ETR. Several groups of ETR studies have measured ETR differently. For example, Zimmerman (1983) measures the effective tax rate as a ratio of income tax to operating income, where income tax represents the total income tax liability adjusted for changes in deferred taxes, and operating income is total sales minus costs of sales. Porcano (1986) measures effective tax rates as a ratio of current income tax to pre-tax book income adjusted by income or losses associated with minority interests and/or extraordinary items. Holland (1998) estimates effective tax rate by dividing a firm's current corporation tax provision by its related level of income.

ETR is usually measured by dividing tax liability by profit. The difference among ETR studies is which taxes to include as the numerator and how to measure profit as the denominator. With regard to the numerator, that is, which taxes should be considered to represent the overall tax burden of a company, a few studies have used tax expenses and excluded deferred taxes (Omer et al., 1993; Kern and Morris, 1992), while others have chosen not to exclude deferred tax (Rego, 2003; Kim and Limpaphayom, 1998; Gupta and Newberry, 1997; and Porcano, 1986). These latter studies chose not to exclude deferred tax because it would control for earning management strategies, since income increasing earnings management increases both the numerator (deferred taxes) and the denominator (pre-tax income). Thus the inclusion of deferred taxes in the numerator does not affect the overall result and the result

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also is not driven by earnings management. In addition, Clowery et al. (1986) argue that to include the present value of deferred taxes is not easy as it cannot be accurately estimated.

With regard to the denominator of ETR, that is, which income should be considered to represent the company's profit, according to Zimmerman (1983), the use of cash flow (instead of operating income) would eliminate the effects of different accounting treatments of income. A number of studies (Phillips, 2003; Rego, 2003; Porcano, 1986) uses pre-tax income as the denominator. They claim that ETR reflects a company's effective tax planning. Hence this study uses pre-tax income as the denominator of ETR.

The difference in measuring ETRs depends on the purpose of the study. Previous ETR studies have focused on different objectives within the study, for example, Buijink et al. (1999) investigated the difference between ETR and the statutory tax rate (STR) across companies; Holland (1998), Callihan (1994), and Manzon and Smith (1994) concentrated on the tax burden of companies; Buijink et al. (2001) focused on corporate tax competition; and Rego (2003) examined corporate tax avoidance. This study utilizes the corporate tax avoidance study by Rego (2003) and measures ETRs as a proxy for corporate tax avoidance based on his study. Rego claimed that since ETRs compare the current tax liability generated by taxable income (to the tax authorities) with pre-tax income based on generally accepted accounting principles (GAAP), ETRs measure the proficiency of a corporation to reduce its current tax liability relative to its pre-tax accounting income. Thus they reflect tax planning and measure the tax avoidance of companies.

According to Rego (2003), tax avoidance activities create book-tax differences, which are either temporary or permanent differences between a company's financial accounting and taxable income. Thus the numerator is based on taxable income and the denominator is based on financial accounting income to accommodate book-tax differences.[1] In addition, Rego (2003) employed sensitivity analysis which excluded deferred taxes from the numerator of ETR and found that they do not affect the main results of his paper. Rego (2003) claimed that firms that avoid income taxes by reducing their income tax payable while maintaining their accounting income will have lower ETR, thus making ETR a reasonable measure of tax avoidance.

The analysis of this study utilizes the concept of effective tax rates (ETR) since it is the most appropriate tool to measure the distribution of a company's tax burden. This measurement was in line with Rego's proxy for tax avoidance that is also consistent with the studies of Mills et al. (1998) and Phillips (2003). ETR is measured as the ratio of current income tax expense to income before income tax.

3.3 Profitability

Manzon and Plesko (2002) suggest that profitable firms can make more efficient use of tax deductions, credits, and exemptions, resulting in greater book-tax differences [2]. Spooner (1986) contends that investment patterns and profitability affect ETR. Siegfried (1972) is one of many from the ETR literature

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[1] According to Mills (1998), whose study was conducted using U.S. data, firms with greater book-tax differences have larger Internal Revenue Service (IRS) audit adjustment that is consistent with greater tax avoidance activities.

[2] Book-tax difference is the different between income reported to shareholders (annual report) and tax authorities (taxable income).

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who argues that ETR can be used to measure effective tax planning, and has hypothesized that firms which have greater resources would develop expertise in tax planning.

Rego (2003) investigates whether economies of scale exist for tax planning, that is whether larger, more profitable, multinational corporations avoid more taxes than other firms. He found that, corporations with greater pre-tax income have lower ETRs. The negative relation between firm size and ETR suggests that firms with greater pre-tax income avoid more income taxes than other firms.

Companies with high profits are likely to employ extensive tax planning to gain tax benefits. Thus a negative relationship between income before income tax and ETR is predicted.

3.3 Industry Effects

Industry affiliation is a potential explanatory variable as tax avoidance activity may depend on the sensitivity of certain industries. By this is meant the nation that different industries may receive different tax treatments and the companies in these different industries might use those incentives differently to engage in tax planning. For example, with studies on U.S. firms, Rosenberg (1969) and Harberger (1959) indicate that the farming, textiles, petroleum, coal products and real estate sectors pay significantly lower income taxes than other sectors. Omer et al. (1993) found evidence of empirical differences in ETR in the pharmaceutical industry and the petroleum refining industry. Another U.S. study by McIntyre and Nguyen (2000) indicates that ETRs vary widely by industry, with oil companies enjoying the lowest ETR.

Kim and Limpaphayom (1998) suggest that industrial effects might be a potential explanation for differences in ETR, and acknowledge the importance of sector effects in their article, but do not include them as explanatory variables. Derashid and Zhang (2003) examine the issues of industry effects on ETR in Malaysia. They found evidence that, manufacturing firms and hotels had significantly lower ETRs than any other public listed companies in Malaysia between 1990 and 1999. Derashid and Zhang (2003) classified industries into consumer, manufacturing, mining, finance, construction, trading, hotel and plantations, whereas this study uses seven categories which are: basic material, industrial, consumer goods, health care, consumer services, utilities and technology in 2001 to 2005. The classification of these categories was based on industry sectors classified in the Thomson Analytic Database. This industry classification is different from Derashid's and Zhang's (2003) study which is based on the Bursa Malaysia classification whereas this study based on the Thomson Analytic Database due to the Thomson Analytic Database includes two important sectors which are frequently given tax incentives, namely the industrial and technology sectors.

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4. METHODOLOGY

4.1 Sample and data collection method

This study commences with the full population of companies listed on the Bursa Malaysia (formerly known as the Kuala Lumpur Stock Exchange, KLSE [3]) from 2001 to 2005. The data chosen start from 2001 as the year that the self-assessment system started to be implemented for companies in Malaysia. The data were in the form of panel data. Selected companies were drawn from seven industries which are basic materials, industrial, consumer goods, health care, consumer services, utilities and technology.

The data were collected from the annual report in the Thomson Analytic Database for 2001 – 2005, resulting in 5,000 observations. Table 1 summarizes the sample selection procedures. Banking and insurance companies were excluded because they are subject to different legislation from the other companies and the regulatory constraints faced by these companies are likely to affect their ETR differently from other companies (740 firm-years). These companies tend to be highly regulated and relatively 'safe' companies in Malaysia. Previous ETR studies (for example, see Rego, 2003; Gupta and Newberry, 1997; Manzon and Smith, 1994; Wilkie and Limberg, 1993; Shevlin and Porter, 1992; Zimmerman, 1983; Wilkie, 1988 and Stickney and McGee, 1982) omitted companies with losses or zero income. These companies will create negative values for ETR which is not susceptible of economic interpretation in this context. In addition, most of the loss-making companies in the data set were loss-making for the entire period of the study. Thus, to be consistent with prior studies, this study also omitted company-year observations with losses or zero income which resulted in 1,970 firm-years. Firm-years with incomplete ETR data were also excluded (645 firm-years). One of the reasons of incomplete data is that the companies that changed their fiscal year-ends during the sample period. The change of fiscal year-ends would create financial reporting gaps or reduced accounting periods. Thus, the exclusion of these companies is to ensure that the ETR calculation is not misleading. The final sample comprises 1,645 firm-year observations as shown in Table 1.

Table 1
Sample Selection Procedure

Number of firm-years 2001 – 2005	5,000
Less:	
Banking and insurance companies	(740)
Companies-years with loss or zero income	(1,970)
Companies-years with missing ETR data	(645)
Number of firm-years available for ETR analysis	1,645

Table 2 shows industry classifications, as per the Thomson Analytic Database classification. However, the industrial classifications of fewer than 10 companies were omitted owing to the loss of degrees of freedom. Thus, the regression for industrial effects dropped two industries, namely oil and gas, and telecommunication.

[3] Kuala Lumpur Stock Exchange (KLSE) has changed its name to BursaMalaysia on 26th April 2004. Even though the period of study covers from 2001 to 2005, the name BursaMalaysia will be used throughout the study.

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Table 2
Industry Classifications

Industry	Frequency	Percent
Indcode0 – Oil and Gas	10	.6
Indcode1 – Basic Material	165	10
Indcode2 – Industrial	600	36.5
Indcode3 – Consumer Goods	555	33.7
Indcode4 – Health Care	45	2.7
Indcode5 – Consumer Services	130	7.9
Indcode6 – Telecommunication	10	.6
Indcode7 – Utilities	35	2.1
Indcode9 - Technology	95	5.8
Total	1,645	100

The test using Tobit estimation, which censored the dependent variable values of ETR by means of truncation at both sides of ETRs to remove the most extreme negative and positive observations and restrict the effect of potential bias. As ETRs can be explained as ratios, they are easily affected by outliers. To correct for such outliers, the truncated regression model was employed. According to Buinjink et al. (2000), this filter is used to ensure that the most extreme observations are excluded from the analysis, without unnecessary loss of useful data. This estimation tends to reduce the influence of outlying observations, thus observations with either an ETR greater than double the statutory tax rate (56 per cent), or a negative/zero ETR are deleted. Therefore only those companies with an ETR in the range between 0 per cent and 56 per cent are considered. This will censor the data set to include a more representative and reliable range of corporate ETRs. This model censored at double value of STR is consistent with model used by Buinjink et al. (2000). The filter only removes a small part of the sample and does not bias the mean upward and downward.

The estimation of tax avoidance behavior is for public listed companies in the Bursa Malaysia and these differ across industrial sectors. It examines the influence of industry effects on tax avoiding behaviour across companies. Different industries which receive different tax treatments would lead to the different effective tax burdens. This test helps to assess whether the industry differences have an effect on tax avoiding behaviour.

5. FINDING AND DISCUSSION

Profitability

The estimated coefficient of profitability appears with a significant negative sign for the regression. The negative relation between profitability and ETR indicates that companies with greater resources have more incentives and ability to engage in tax planning. This finding is consistent with those reported by Rego (2003) and Manzon and Plesko (2002). Rego (2003) documented that corporations with greater pre-tax income have a lower ETR and claimed that firms with greater pre-tax income avoid more income

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tax than companies with lower pre-tax income. Manzon and Plesko (2002) stated that profitable companies have a lower ETR as they are able to use tax deduction, credits, and exemptions with greater efficiently than less profitable companies.

Table 3
Regression Results of Tax Avoidance Activity on Industry Differences

Industry Category	Profitability	No of Observation
Basic Material	-1.4954* *(.3908)*	82
Industrial	-.8292* *(.1869)*	369
Consumer Goods	-.0404 *(.2512)*	266
Health Care	.2513 *(3.8894)*	19
Consumer Services	-.7487*** *(.4376)*	80
Utilities	.5280 *(.3619)*	33
Technology	4.6213* *(1.0859)*	27
Note: **indicates statistical significance at the 1% level* ***indicates statistical significance at the 5% level* ****indicates statistical significance at the 10% level*		

Table 3 shows whether or not statistically significant relationships exist between tax avoiding strategy and the profitability variable in each industry. The profitability variable has the expected negative sign and was significant in basic material, industrial and consumer services. However, the variable was significant but has different sign from expected in the technology regression.

Industry Effect

In general, the four industries showing the strongest correlation between profitability and tax avoidance activity are basic materials, industrial, consumer services and technology, whereas the other industries, consumer goods, health care and utilities show weaker correlation. The results confirm the importance of the industry effect in the relationship between profitability and tax avoiding activity.

Both the basic material sector and the industrial sector consistently show lower ETRs compared with other industries. Particularly, companies with higher profitability in basic material and industrial sector, pay significantly less tax than any other industry. It is not surprising as it is likely that the industrial

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sector [4] enjoys various tax benefits in order to promote both economic and social goals, including enhancing efficiency or competitiveness, fostering high-technology, protecting domestic products, increasing exports and widening job opportunities. Alavi (1996) indicates that there is in Malaysia long standing industrial policy to promote companies in the manufacturing sectors. The Malaysian government provided various tax incentives to stimulate and support such companies. Several incentives have been provided, including incentives to strategic industries, incentives to strengthen industrial links, incentives for industrialised building systems and incentives for outsourcing manufacturing activities. The incentives given include pioneer status, investment tax allowance, reinvestment allowance and accelerated capital allowances (up to 100 per cent tax exemptions).

Both basic material and industrial sectors recorded that higher profitable companies pay less tax which is confirmed from the regressions. This result support the hypothesis in that, more profitable companies have more resources and are thus better able to engage in effective tax planning. These findings are consistent with those reported by Rego (2003) and Manzon and Plesko (2002), normally that more profitable companies pay lower tax than less profitable companies. Both basic material and industrial sectors indicated that the more profitable companies have paid significantly less. This result suggests that the tax incentive for the industrial sector in Malaysia (which provides higher capital intensity companies with an advantage from accelerated capital allowances under the Promotion of Investment Act (1986)), have resulted in lower ETRs.

Consumer services sectors also recorded that higher profitable companies pay significantly less tax than less profitable companies in this sector. Results from the consumer goods reveal that profitability has negative relationship with ETR. The basic principle of business activities for consumer goods is to meet the basic needs of the nation. The results confirm that this sector is avoiding tax but not aggressive or significant.

Results from the technology sector indicate that the industry effects exert a significant influence on tax avoiding activity. However, the technology sector shows the more profitable companies have a positive influence on ETR. In other word, in the technology sectors, more profitable companies pay more effective tax than less profitable companies. The technology sector is mainly based on developing and providing technology and technical support to the nation. This sector is important as it carries out the challenges to fulfil Vision 2020. The development of technology plays a crucial role in the government's plans. The Malaysian government focuses on national science and technology to sustain economic development and to improve quality of life and national security in the 21st century. One of the policy goals of Vision 2020 is that science and technology are central in building a more innovative and vibrant economy. Thus one explanation of the significant positive relation between profitability and ETR in this sector may be that this sector is important and under the supervision of the government and are thus unable to engage in more aggressive tax planning. The results in the health care and utilities category indicate that profitable companies have a positive influence on ETR. Even though the result has contradicts sign, but predictable as both sectors are important which involves benefit to the nation. The

[4] Both basic material sector and industrial sector are considered as manufacturing or industrial sector. Basic material mainly focus on manufacturing local resources such as quarrying and mining, while the industrial sector engages in manufacturing activities other than basic material sector.

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utilities sector supplies basic needs to the nation (water supply, waste management, gas power generation, construction, environmental services and trading) and pharmaceutical sector are to sustain nation health. Both sectors are important and under the government supervision, thus unable to engage in the aggressive tax planning.

6. CONCLUSION AND FUTURE RECOMMENDATION

Tax collection generates large amounts of revenue and is a vital source of income for government to promote overall economic stability and growth. Since Malaysia implemented self-assessment system for companies in 2001, it is important to ensure compliance by taxpayers. The aim of this study is to examine the relationship between different sectors and tax planning activity, resulting in lower effective tax rate (ETRs).

The results reported that companies across different industries do have significantly different characteristics and levels of tax avoiding activity. It shows that companies pay less tax in Malaysia is in the basic material, industrial, consumer goods and consumer services.

The results confirm the importance of industry differences in explaining the corporate tax burden. The evidence shows that companies across different industries do have significantly different levels of tax avoiding activity. Four sectors, namely basic material, industrial, consumer services and technology demonstrate a high correlation between profitability and tax avoidance activity. The evidence, however, is not always consistent with predicted direction across industries, particularly for the technology sector.

In the technology sector, it appears that companies with higher income would have a higher ETR than other companies. Thus, not all companies with higher income would pay less tax, especially for the companies under the government supervision.

It remains to conclude this study by suggesting recommendation for future research. Because of Malaysian financial accounting law, only public listed companies have to disclose their financial statements. Thus this study does not examine the association between corporate tax avoidance and non-listed companies in Malaysia. In the future, as more data becomes available, one could include tax avoidance in non-listed companies.

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